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In the Supreme Court of the United States

OCTOBER TERM, 1958

COMMISSIONER OF INTERNAL REVENUE, Petitioner

vs.

CHARLES M. KILBORN AND ANGELINE W. KILBORN

Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The findings of fact and the opinion of the Tax Court in *Commissioner vs. Kilborn* are reported at 29 T. C. 102. The United States Court of Appeals for the Fifth Circuit reversed the Tax Court in ..... F (2d) ..... (5 Cir. 1958).

JURISDICTION

The jurisdictional requisites are adequately set forth in the Petition.

QUESTION PRESENTED

The question as posed by the Petition for Certiorari is not the question presented by the record in *Charles M. Kilborn.* The precise question presented by the record in *Charles M. Kilborn* may be stated as follows:

> "Whether sums credited by a bank to a special reserve account pledged irrevocably to secure all sums owing by all customers of an automobile dealer on any of the conditional sale contracts discounted by the dealer with the bank, under arrangements calling for full recourse on the dealer as to all sums owing under the aggregate

of all contracts discounted, constitutes income of the dealer in the year credited or in the year paid the dealer by the bank, where any payment from the reserve account to the dealer at any time rested entirely in the discretion of the bank."

STATUTES AND REGULATION INVOLVED

The statutes and regulation are adequately set forth in the Petition at Appendix B.

STATEMENT

The Government's statement of the fact situation in *Charles M. Kilborn* (Page 6, Application for Certiorari) is inadequate, inaccurate and misleading as a presentation of the facts established by the record.

Specifically the portion of the Government's statement with regard to *Kilborn* to which exception is taken is as follows (Petition, Page 6):

> "The partnership sold cars on credit, receiving notes of purchasers for the balance due on the unpaid purchase price. Pursuant to written contract with the First National Bank of Mobile, the partnership sold and transferred the notes to that bank, with full recourse, and received the face amount of the notes, less the bank's discount, the amount required for recording the paper and the gross premiums on the insurance the bank was to take out. Of this purchase price, the bank paid or credited to the unrestricted use of the partnership the unpaid balance of the price for which the car was sold, less any financing charges or other charges imposed on the balance, or the National Automobile Dealers' Association's average loan value, whichever was lower. Any balance remaining of

the purchase price of the notes was credited to a special reserve account in the name of the partnership which by agreement was pledged by the partnership to the bank as collateral security for the payment by it of any sums which it might then or thereafter owe to the bank."

The correct fact picture from the Record (pages 26-35) is:

Kilborn was a member of a partnership selling used automobiles (Record, Pages 56 and 57). The partnership reported on a *cash* basis although the Tax Court in its opinion below held that the partnership was not on a cash basis because an inventory of automobiles was used; hence it said no other method than accrual would properly reflect income (not conceded by Kilborn to be sound reasoning for putting all of its methods of bookkeeping on a purely accrual basis) (Record, Page 39).

The partnership depended upon the local bank to finance time payment sales of automobiles at retail to customers. To finance these time sales the bank and the partnership entered an agreement covering the financing by the bank of time payment sales. By the contract, when the dealer sold a car on time the dealer added to the unpaid balance of cash selling price remaining after credit for the down payment, a sum equal to the amount necessary to record the paper, the gross premiums on insurance to be charged and an amount not greater than the rate in a specified chart to represent finance or carrying charges. The total of the unpaid balance of cash selling price plus these charges, (representing the total time payment balance arrived at) was to be made payable in installments by the buyer. The transaction was to be evidenced by a conditional sale contract retaining title in the dealer until the time bal-

ance of purchase money unpaid was paid by the customer in full.

Under this master financing contract between the dealer and the bank the dealer presented the retail conditional sale contracts to the bank with *full recourse* on the dealer. This paper was then discounted by the bank at the rate of one-half of one per cent per month computed on the actual unpaid balance of the *cash* selling price plus premiums for insurance plus recording fees, (i.e. excluding in the computation a discount on the amount included in the time purchase balance for "finance charges"). The dealer was then advanced by the bank for the dealer's unrestricted use the amount representing the unpaid *cash* for which the car was sold without inclusion of financing or other charges imposed on the buyer (subject to limitations that the amount advanced the dealer should not exceed the loan value of the car sold according to a standard average loan valuation table). After the bank paid costs of recording the contract, gross premiums for insurance on the automobile and had made the payment of unpaid cash selling price to the dealer the remaining amount (the difference between the face value of the total indebtedness evidenced by the contract and the total amounts actually disbursed by the bank) was credited to a special "dealer reserve" account in the dealer's name on the books of the bank. This credit stood forthwith pledged to the bank as collateral security to secure all sums owing by *that* and *any other* customer of the dealer owing under any automobile sales contract financed for dealer through the bank or any other sums which dealer owed bank by virtue of dealer's recourse endorsement of the various contracts financed or which the dealer might otherwise owe the bank under the financing agreement between the dealer and the bank.

Under the contract, when the title of a conditional sale contract had been transferred to the bank, the bank devoted reasonable efforts to collect amounts becoming due from the customers. If two payments from the customers became delinquent the dealer was required by his contract for *full recourse* on the dealer to repurchase the contract forthwith. Repurchase was to be made by the dealer from *other* funds for the *face amount remaining unpaid* less "unearned discount" which "unearned discount" was credited against the unpaid balance first; the remaining repurchase price the dealer was required to pay from the dealer's funds. If the dealer failed on demand to buy back the contract the bank *could charge* the entire purchase price back against the amount in the dealer reserve account and effectuate a retransfer of the contract to dealer in that manner. So long as any indebtedness was owing on any one or all of the total number of contracts financed by the bank, the dealer had *no right* to demand or receive *any* portion of the reserve account.

No part of the amount credited to the dealer reserve accounts was reported by the dealer as income in the year when credited to the *special reserve* account. No repurchase of a defaulted contract by the dealer was charged by the bank against the reserve account in any year. In 1949 when the bank considered the reserve account sufficiently large for collateral security purposes, but without contractual obligation to do so, it released and paid the dealer in one sum, a part of the total credited to the reserve account. ($5,000.00) This sum, when paid by the bank to the dealer, was reported as income when actually received (in 1949).

Whether the amounts credited to the reserve account were taxable to the dealer when credited or taxable only when actually paid the dealer, is the point in dispute.

The taxpayer insists the credits did not constitute income when credited but were sums contingent and uncertain and incapable of ascertainment that taxpayer might ever receive them. Hence these credits to the reserve account are not income until received by the bank's voluntary payment of funds to the dealer, whether the dealer be on a cash basis, accrual basis or some hybrid of the two.

REASONS FOR DENYING THE WRIT

Kilborn presents no novel question. Any seemingly conflicting result of decisions in various circuits arises from a different fact situation or conflicting applications of principles long stated by this Court rather than a disagreement as to principles involved.

In *Spring City Foundry Company vs. Commissioner*, 292 U.S. 182, 184, 185, 54 Sup. Ct. 644 (1933) the Court stated the principle:

> "Keeping accounts and making returns on the accrual basis as distinguished from the cash basis, imports that it is the *right* to receive, and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues."

In *North American Oil Consolidated vs. Burnet*, 286 U.S. 417, 423, 52 Sup. Ct. 613 (1931) the holding was:

> "For the company was not required in 1916 to report as income an amount which it might never receive. (cases omitted) There was no constructive receipt of the profits in that year because at no time during the year was there

a right in the company to demand that the receiver pay over the money. Throughout 1916 it was uncertain who would be declared entitled to the profits. It was not until 1917 when the District Court entered a final decree vacating the receivership and dismissing the bill that the company became entitled to receive the money. Nor is it material, for the purposes of this case, whether the company's return was filed on the cash receipts and disbursement basis, or on the accrual basis. In neither event was it taxable in 1916 on account of income which it had not yet received and which it might never receive."

That these principles were well understood and applied to financing arrangements essentially the same as *Kilborn* was evidenced by *Keasbey & Mattison Co. vs. United States*, 141 F (2d) 163 (3rd Circuit) as far back as 1944:

"It is the right to receive and not the 'actual receipt' of an amount which determines its accruability. But the right to receive must have become fixed before the right can be said to accrue."

Later in the opinion that Court observed:

"Whether the plaintiff would ever acquire a fixed right to receive anything from the reserve fund was contingent and unascertainable throughout the tax year."

In *Kilborn* the events which create the dealer's liability to the bank under its full recourse agreement by its master finance contract, viz: the execution of the master contract and incident of sales under that contract with full recourse, arise at the same instant the Commissioner would "accrue income" as a result of the transaction.

The companion cases in the Government's petition differ in some respects from the *Kilborn case, supra.* In *United States vs. Hines Pontiac,* F (2d) (5 Cir. 1958) and *United States vs. Modern Oldsmobile, Inc.,* F (2d) (5 Cir. 1958), the agreements between the dealer and the financial institution permitted the financial institution to remit amounts in excess of a certain percentage of the outstanding receivables. Also, the agreements carried only partial recourse provisions. As can be seen in these latter types of arrangements, prevalent in the above cases, the finance company used the reserve as its only buffer against future losses because of their non-recourse nature.

In *Kilborn, supra,* the reserve account was subject to the following contingencies:

1. The Taxpayer could only receive the amounts in the reserve account after all liabilities as a result of all transactions thereunder had been satisfied.

2. The conditional sale contracts were always with full recourse on the dealer.

3. There was never any arrangement for the Taxpayer to demand any amounts of the reserve irrespective of the amounts of the outstanding receivables so long as any sums owing the bank under the contract remained unpaid.

It would appear that the granting of certiorari in this case would only further add to that long line of cases decided by this Court concerning the question of when income accrues.

This conclusion is further buttressed by the decision of *Texas Trailer Coach vs. the Commissioner,* 251 F (2d) 395, 403, 405, (5 Cir. 1958), which held as follows:

> "The closer a tax comes to giving effect to the economic realities, the more bearable it is as the price of national

security and of civilization. The real trouble in this case is that the taxpayer is asked to pay a tax on money he did not in fact receive and had no right to receive during the taxable year in question. He may never receive it, but he is asked to deplete his cash in order to pay it. If compelled to pay, the more business he does—the worse off his cash position will be. But, if a more realistic view is taken, the Government will not be deprived of any tax because when the contingent credit materializes as a fixed, ascertainable claim or if payments are received from the reserve account, the taxpayer must then include the fixed claim or payments in his taxable income."

and further—

"The dealer does not have a fixed, ascertainable claim to the reserve at the time of the sale or holdback; he has a claim for some time in the future—provided the aggregate of the amounts in the account exceed fifteen per cent on the balance due on all contracts. The account may never exceed fifteen per cent. In this case the dealer waited three years to receive any payments from the reserve account. Thus, the dealer's rights to receive payments from a particular sale to a trailer purchaser depends upon not only that purchaser not defaulting but upon other purchasers not defaulting. It depends ultimately, upon the level of the taxpayer's business, and perhaps the level of business generally, (1) being sufficiently high for the reserves to build up to more than fifteen per cent of the unpaid balance on all trailer contracts and, thereafter (2) not declining sufficiently for the defaults of all trailer purchasers to cut into the reserve so as to reduce the account

below fifteen per cent of the unpaid balance due on all contracts."

The Government suggests that the Court may wish to hold its petition for certiorari in *Kilborn* and the companion cases pending decision by the Court in *Commissioner vs. John R. Hansen and Shirley G. Hansen*, No. 380, this Term and *Commissioner vs. Burl P. Glover*, No. 381, this Term. We would prefer that the Court either grant or deny certiorari in order that, if granted, we may be heard on the issues before the Court.

We respectfully ask that certiorari be denied.

Respectfully submitted,

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